

IRS News Release

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IRS Helps Military Personnel Get New Law's Tax Breaks

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WASHINGTON — The Internal Revenue Service is helping taxpayers use a new law providing income exclusions for death benefit payments and certain home sales. Both provisions are retroactive, so some qualifying taxpayers must file amended returns to claim these tax breaks. The IRS asks them to put the words "Military Family Tax Relief Act" in red at the top of such returns to speed processing.

The new law doubled the benefit paid to survivors of deceased Armed Forces members to \$12,000, made the entire amount tax-free and made the changes effective for deaths occurring after Sept. 10, 2001. Previously, only \$3,000 was tax-free. Recipients who already paid tax on benefits received for deaths after the effective date may file an amended return on Form 1040X, reducing their adjusted gross income by the \$3,000 they had reported as taxable. Those who receive such "gratuity" benefits in 2003 and future years will not have to report them on their tax returns.

Taxpayers may exclude gain on a home sale, provided they have owned and used the home as a principal residence for two of the five years before the sale. A reduced maximum exclusion may apply to those who satisfy part of the two-year rule. Military personnel often retain ownership of a home while away on duty but eventually sell it without returning to live in it, perhaps failing the use test completely.

The new law allows persons on qualified extended duty in the U.S. Armed Services or the Foreign Service to suspend this five-year test period for up to 10 years of such duty time. A taxpayer is on qualified extended duty when at a duty station that is at least 50 miles from the residence sold, or when residing under orders in government housing, for more than 90 days or for an indefinite period.

This change applies to home sales after May 6, 1997. A taxpayer may use this provision for only one property at a time and may exclude gain on only one home sale in any two-year period. Although an amended return must usually be filed within three years of the original return's due date, the law gives qualifying taxpayers who sold a home before 2001 until Nov. 10, 2004, to file an amended return claiming the exclusion.

A taxpayer may use Form 4506, "Request for Copy or Transcript of Return," to get an earlier year's tax return. This form and Form 1040X are available on the IRS Web site at www.irs.gov, or by calling 1-800-TAX-FORM (1-800-829-3676).

Here are four examples illustrating how the new home sale exclusion rule works:

Example #1 — Lt. Green owned a house in Georgia and lived there from December 1988 until deployed overseas in January 1991. When he returned to the United States in July 1999, he was stationed 90 miles from the house. Preferring not to commute this distance, he sold the house four months later, realizing a gain of \$150,000. Because he had not used the house as his principal residence during the 5 years preceding the sale, he reported this capital gain on his 1999 return. Under the new law, he can disregard both the 8½ years he was overseas and the 4 months after his return to the States, since he was stationed more than 50 miles from old residence. His five-year test period for ownership and use now consists of the 5 years before January 1991, when he went overseas. Since he owned and lived in the house for more than two years during this test period, he may exclude the gain on the sale. He must file an amended return by Nov. 10, 2004, to recover the capital gain tax paid on the 1999 return.

Example #2 — Assume the same facts as Example #1, except that when Lt. Green returned to the U.S., his duty station was 40 miles from the house. Only the time overseas may be disregarded, because his duty station after returning to the U.S. was within 50 miles of the old residence. His five-year test period for ownership and use now consists of 4 months in 1999 and the 56 months before January 1991, when he went overseas. Since he lived in the house for more than two years during this test period, he may exclude the gain on the sale. He must file an amended return by Nov. 10, 2004, to recover the capital gain tax paid on the 1999 return.

Example #3 — Col. White owned and lived in her Ohio house for three years before being stationed overseas in January 1988. She was still overseas when she sold the house in January 2003. She may disregard only 10 of her 15 years overseas, so her 5-year test period consists entirely of years in which she did not live in the house, leaving her not eligible for the home sale exclusion.

Example #4 — Sgt. Brown owned and lived in a Virginia townhouse for 10 months before being deployed overseas in February 1991. She returned in 1995 and lived in the townhouse for 16 months before she was assigned to a Texas duty station in late August 1996. She married and when the couple returned to Virginia in July 1999, they bought a nearby house. In July 2001, they sold the townhouse. Having lived in the townhouse only one month in the five years preceding its sale, they reported the capital gain on their 2001 return. Under the new law, they may disregard the time spent overseas and in Texas when determining the 5-year test period, which would then consist of the two years from July 1999 to July 2001, when they lived nearby, the 16 months she lived in the townhouse in 1995-96, and the 20 months before the February 1991 overseas deployment. During this test period, Sgt. Brown owned and lived in the townhouse for 26 months, so she may exclude up to \$250,000 of gain on its sale. Because her husband never lived in the townhouse, he does not qualify for any exclusion. The Browns have until Apr. 15, 2005, to file an amended return claiming a refund of the capital gain tax paid on the excludable amount.